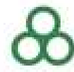
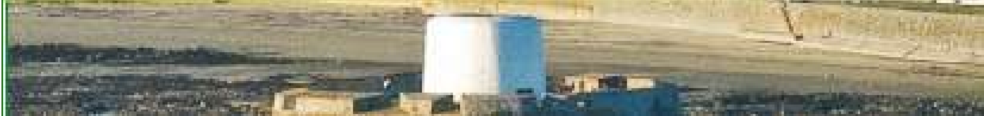


cannon asset management

newsletter

October 2015



Summary

This quarter has seen the great China market scare. Global equity markets sold off with the large correction of Chinese equity markets. Chinese authorities tried to arrest its falling market, but failed in their attempts. Additionally, China allowed its currency to devalue modestly, which followed a collapse in oil and commodity prices. As a result many emerging market's currencies and stock markets corrected, worried about lower revenues and greater Chinese competition.

Developed markets followed these moves, reflecting earnings concerns of Emerging Market and Chinese demand. Also, equities had been poised for a correction. The S&P 500 price earnings ratio was high (86% above levels over the last 90 years). Also, its momentum was breaking down: fewer stocks were above their moving averages, a range of industries were correcting within the broader indices and it was a mature rally - one of the four longest runs in the last 100 years at 6.5 years.

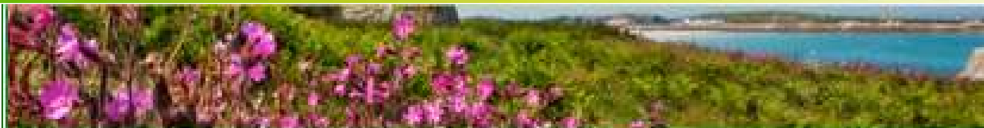
However, markets were not in bubble territory, economic indicators are currently good and simulative policies around the world are in place. Weak commodity prices probably reflect past excess investment rather than an indicator of falling global demand, particularly for energy. Long term, this may be an outsized correction provided equity, currency, bond and commodity falls do not impact underlying economies and company profits. We felt that US interest rates should have risen in September and were not too surprised that markets fell when this failed to occur.

Most of our long held views remain in place. While recessions and bear markets will occur in the future, it does not seem likely in the near term. For conservative investments, the immediate crisis will probably pass with little long term impact.

Further volatility is still likely. Unfortunately, the US congress will need to agree a budget during October to avoid a government shut down and agree an increase in the debt ceiling in December. Extreme Republicans do not make either a foregone conclusion. As 2016 is an election year, grandstanding is likely from some politicians.

We continue to have a long term target of 4-5% for the US Treasury 10 year bond. Corporate bonds and high yield bonds remain vulnerable to inflation, earnings disappointments or M&A activity. US short term rates should rise in the next 6 months and in the next 12 months for the UK, which could be positive for equities.

Markets



Fixed Interest

Renewed oil and commodity price weakness along with concerns over economic growth in emerging markets, particularly in China led to lower bond yields as investors sought the safety of less risky assets.

We continue to think the US growth & interest rates will affect most countries irrespective of their local circumstances. The Euro area seems to be gaining momentum despite known problems. Short term US and UK rates should rise during the next 6-12 months.

Short Rates

Currently US interest rates should be 2.61% higher (2.10% last quarter) based on long term inflation, real return and unemployment inputs. The Fed Open Market Committee

mean forecasts fell again: Sept: 2015 – 0.42% (0.566%), 2016 – 1.49% (1.75%) and 2017 3.00% (3.00%).

Our estimates of UK short rates indicate that they remain too low, by about 2.70% (2.55%). European rates are about 0.05% too high (0.20%) for about 9% unemployment assuming no price inflation. However, for non-core Euro countries rates are about 3.66% too high (4.45%, 2.34% improvement in three quarters).

Markets are still pricing US & UK short rates to rise significantly on a 2-5 year time frame, however Europe and Japan remain challenged and their rises could be delayed.

Longer Rates

Developed countries' 10 year bond yields remained above their lows of last year. Longer term rates of 4-5% on 10 year US Treasuries (vs 3% for short rates in 2017) should eventually be expected. Their current yield is 2.03% compared to 2.97% in December 2013, but this is well up from their lows. Weaker Euro zone government bond yields have risen strongly too.

Credit & Emerging Markets

Investment grade corporate bonds are better value than government bonds. Improving economies and profits make defaults less likely but emerging market bonds corrected due to Chinese growth worries.

Bond Themes & Ideas

We expect US rate rises in 2015, particularly if there is no evidence it will damage the US recovery. Short dated bond yields will rise as a result. The UK may tighten in 2016.

Currently markets expect short term rates to match those of 5-10 year maturities within 2-3 years. If this happens, long rates should rise but current 5 year bonds may not as they become short dated over the next few years.

Deflation is receding but is not yet history in Europe. The misguided austerity and monetary policies of the Eurozone continue to damage the continent and individual countries, in some cases on a scale last seen in American during the 1930's.

Loan demand is poor, but improving. Eurozone bank stress tests are finished for now but QE will benefit banks rather than other bond investors, limiting the impact on the economy. Greece remains in dire financial straits and could set an ominous precedent for the Eurozone. Anti-Euro and anti-EU political parties continue to strengthen across the union, assisted by prejudices about Mid East refugees. Improving economies are moderating this trend.

Equities

Markets reached new highs and all-time highs in some cases during the second quarter. Broadly speaking equities are above fair value on long term measures (CAPE) and only Emerging Market equities look undervalued on a 7 year view.

The relative importance of market drivers are changing but improved cyclical profits underpinned by economic recovery remain key. Others are jostling with market volatility and emerging market developments. Items include increased dividend yields, share buy backs from historically low levels, increased debt to enhance equity returns, increased M&A activity and corporate pension liabilities due to bond and equity market gains moves.

Enduring gains will depend upon rising earnings rather than the expansion of the price earnings (PE) multiples of recent years. But markets could move to over-valuation through further expansion of current PE multiples and QE. A strengthening dollar and sterling will favour domestic activities over multinationals.

In the US, high quality stocks are better value than other types but prospective returns remain below both Emerging Markets and the 6.5% long term real return of US equities.

US Equities

Government deficits should improve, wages are growing, US household net worth is rising, housing is in a second year of recovery and debt servicing costs remain low. The cyclical side of the US economy remains in recovery but quality & growth stocks are yet to really perform. Equities are relatively expensive but are not at record levels.

UK Equities

The May election result reduced political uncertainty. The March budget forecast about a 5% government deficit (6.6% last year) and optimistic improvement in government debt requiring 4% reduction in spending. This is despite much improved growth, unemployment, retail sales and consumer & business confidence. Domestic growth is strong but based mostly on higher consumer debt. Mid-caps are still expensive.

European Equities

There are signs of deflation being addressed by policy makers. However, the Euro and government finances could upset plans, possibly making domestic firms preferred over exporters. European equities still appear to be good value, certainly on a relative basis.

Japan Equities

Bank of Japan stimulus measures and mixed signs of some reflation success lifted markets earlier this year. Gross debt remains high relative to GDP which could cause significant problems. Japanese equities are among the cheapest of major markets.

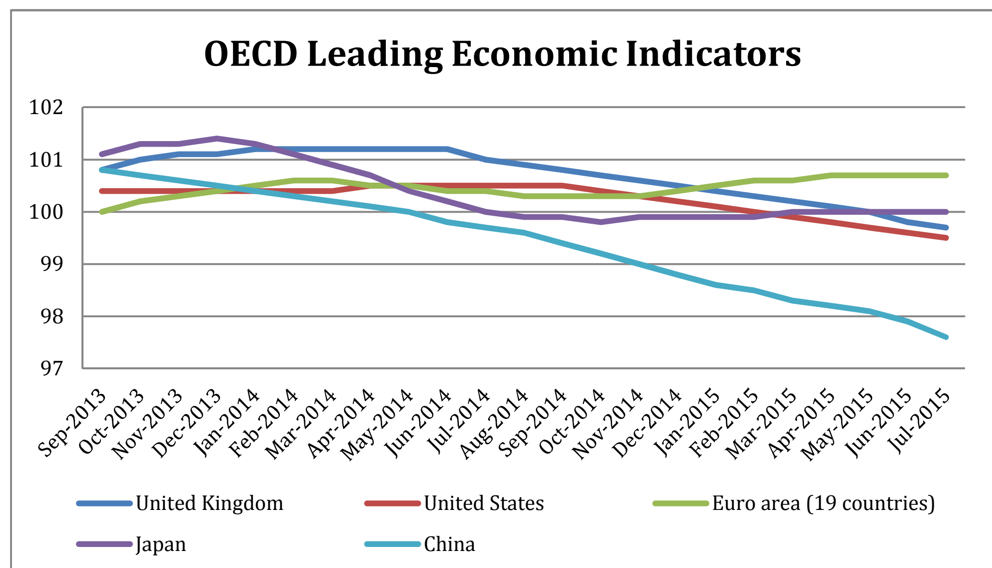
Emerging Markets Equities

These represent best value, but are volatile as seen in China. FTSE EM index is now on 9.33 times next year's earnings.

Economic Outlook

Estimates of growth have decreased since our last newsletter, except for the Eurozone which was upgraded. Global growth of 3.0-3.3% (3.3-3.5%) this year and 3.6-3.8% (3.8%) for 2016 are expected. Next year the US should see 2.4-2.6% (2.2-2.8%), UK 2.2-2.3% (2.3-2.5%), Eurozone 1.7-1.9% (1.6-2.5%) and Emerging Markets 3.3-4.7% (4.7%). (Sources: IMF, OECD)

US data is sporadic with some weakness in Q1 and in government finances. Growth averaged over 2%, credit growth was over 7%, employment rates, participation rates and wages are all improving. September saw US consumer confidence surprise with a 103 vs 96.9 expected. The Federal Reserve has removed $1trn of QE but Japan intends to provide $0.75trn and Europe a further $1.25trn (€1trn). The net impact should be positive for the world, provided it is actually supplied. Equally important however, is spending (demand) recovery. Oil price remains a net benefit.



China (the largest source of global growth) is still dealing with its adjustment to a more mature economy, with long term growth officially lowered below 7% per year. Europe and Japan remain the global laggards which may have the biggest impact on global growth. Higher US interest rates will place stress on economies with USD debt.

China is taking action to stimulate its economy with eased interest rates and capital adequacy requirements. It is still trying to rein in lending, increase domestic consumption and introduce market forces to domestic debt markets.

There have been some notable positive developments in Europe. Actions to reduce deflation pressures include negative interest rates and QE announced by the ECB. The EU has softened its position on the French and Italian budget deficits but Greece remains a basket

case that could damage Eurozone credibility & bond markets.

The ECB announced substantial quantitative easing of over €1tn due to developing deflation. While the scale is enough to meet the credit requirements for the Euro area's private sector, public sector deficits and their funding remain a concern. The bond purchases will benefit banks rather than other holders of bonds, limiting the impact on the economy. Additionally banks can borrow at 0.05% for 4 years, profiting from buying bonds with loans – re-building their balance sheets.

As argued previously, a lost decade of growth similar to Japan remains a significant risk for Europe. With Germany's guidance, Europe is being required to reform markets and reduce spending in a poor growth environment. Simultaneously, the Euro credit supply is weak due to stress tests and banks' reducing loans books to meet their capital requirements. Northern Europe remains wary of lending capital to weak, uncompetitive Southern economies except via central bank funding.

One hope for Europe is that the new banking framework will create a single banking system that could improve credit supply. Along with QE, this seems to be showing a sign of working as bank lending is expanding.

The UK continues to progress. Growth, employment and the first signs of wage improvements are evident. Tax revenues are showing signs of improvement but serious, sustained deficit reduction weighs on the recovery. Some political uncertainty has been removed but continued membership of the EU is not assured.

Japan's progress remains uncertain and the BoJ has announced quantitative easing equal to 16% of GDP, intended to devalue the Yen and stimulate inflation. Further VAT tax rises are planned, though prior increases poleaxed consumer spending, threating growth. The national pension scheme is reducing bonds from 60% to 35% of assets and raising equities from 24% to 50% of assets. However corporate cash surpluses continue, which are driving government deficits and low private sector spending.

Emerging markets will likely become more diverse in their prospects. Sound economies will prosper, but weak ones will suffer. A strengthening US dollar is making foreign debt servicing & repayment expensive, placing stress on some countries. This is a more normal state of affairs compared to the past 6 years.

Themes & Ideas

Our views evolve, usually slowly as events unfold and we tend to follow a value philosophy which results in measured changes in portfolios. Here are some of our thoughts.

How Relevant is China to Developed Market Economies?

Exports to China are about 1% of US GDP (2014, source Bloomberg) and about 2% of German GDP (2014, source: Bloomberg). So, a decline of Chinese growth from 9% to 5% is trivial to both economies, despite popular perception. This 4% drop would imply about 0.04% lower growth for the US and about 0.08% for Germany. For the UK the figure would be about 0.02%. Even if we double the results to imply a similar reduction for other emerging markets (as China is about half of emerging market growth), the results remain small.

Germany, Debt, Immigrants and Credibility

Germany faces very significant burdens of unfunded liabilities and infrastructure spending. The country's unfunded liabilities are 400% of GDP and it has about €1tn of cost to exit its nuclear energy program alone. Commentators regularly mention the country's crumbling and inadequate infrastructure. This is one source of the country's obsession with austerity – it needs to save and avoid tax calls from Europe.

The well intentioned welcome to Middle East refugees also improves an aging population, but studies by the IMF and other indicate that at best immigration has little economic benefit. Basically, immigrants must earn significantly more than average earnings (which is rare) to enhance the wealth of the country after their settlement costs.

Unfortunately in modern service based economies high paid, unskilled jobs are rare. As most immigrants (circa 70%) are unskilled - even assuming good language skills - the net benefit is likely to be low. One estimate is that 5 million such immigrants (6.25% of Germany's population) would cost €38bn per year or about €1tn over 30 years.

So, are ultra-low bond yields compatible with very large and growing government liabilities? If not where will the money come from, more austerity perhaps or looser money policy?

The Europe and the Euro

The Euro is one of the great unresolved issues in world economics. It hangs over the region's prospects & politics like a sword waiting to fall. The Euro was and is a political project, which the European "establishment" is clinging to in desperation.

It was supposed to lead to greater European integration, eventually full political, fiscal and banking union. It has been disastrous (for some countries) due to these unresolved issues, though they are not the root of its problems. It was also supposed to generate significant economic benefits, which are now totally overwhelmed by lost economic output in many countries. This in turn is discrediting the Euro and the whole governing class of the EU.

At the moment, it has survived but the possibilities of defaults on national debt, a lost decade of growth, a generation of vast unemployment and social ills, resentment between Euro zone members and political disintegration of the whole project remain. Currently, leaders of national governments in Europe are coming under threat from anti-EU parties, even in Germany, so change may yet occur, though slowly.

The Euro's fundamental problem is the "one size fits all" interest rates and economic policy applied to economies with different levels of productivity, wealth and labour market flexibility. It is worsened by the lack of Eurozone institutions to address the differences, such as fiscal transfers, a banking union and ultimately a single elected body representing the whole area rather than the national governments currently calling the shots. Domestic market policies are also a major source instability.

It is possible that the Euro will continue in its current incarnation, inflicting enormous damage on member states and their populations but there is also the possibility that it will change. QE is the first sign of this. The costs of the Euro will continue to grind upwards in the form of social damage and lost growth if the program is not successful. In any event, the deeper economic problems in many countries will endure, similar to Italy's southern regions or Canada's Maritime provinces. (I recommend Roger Bootle's "The Trouble with Europe" for detail analysis.)

End of the Great Bond Bull Market

We are of the view that the great bull market in bonds since 1979 is probably now over. Rallies for government bonds will occur however if economic performance deteriorates, depending upon prevailing yields. This past year seems to have proven that view correct for now. However Euro QE could derail our view as market forces are mitigated.

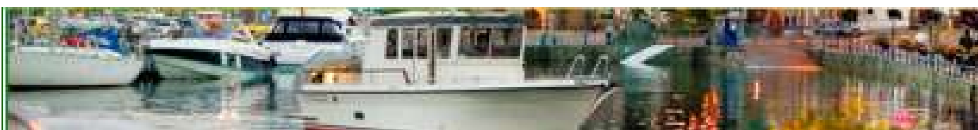
Deflationary stresses in Europe, China and Japan prevailed last year resulting in gains for bonds. Also, US bonds rallied due to dollar strength and low inflation. We remain concerned that there could be a massive fall in government bond values due to increasing inflation or failing political support, particularly in Europe. Last year Greek bonds fell about 30% from September to December on political concerns. Corporate bonds may be vulnerable depending upon the nature of any slowdown, earnings disappointments or takeovers.

Simply holding low yielding bonds is not our preferred strategy and we expect longer rates to eventually increase. In any case, short term rates should now move toward longer rates as quantitative easing (QE) is stopped in the UK and US.

Emerging Market Spending & Stock Values

Emerging market weakness is causing surprises in the performance of firms with heavy growth exposure to that part of the world. This may prove to be an excellent buying opportunity for this long term structural growth theme.

Contact Us



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